



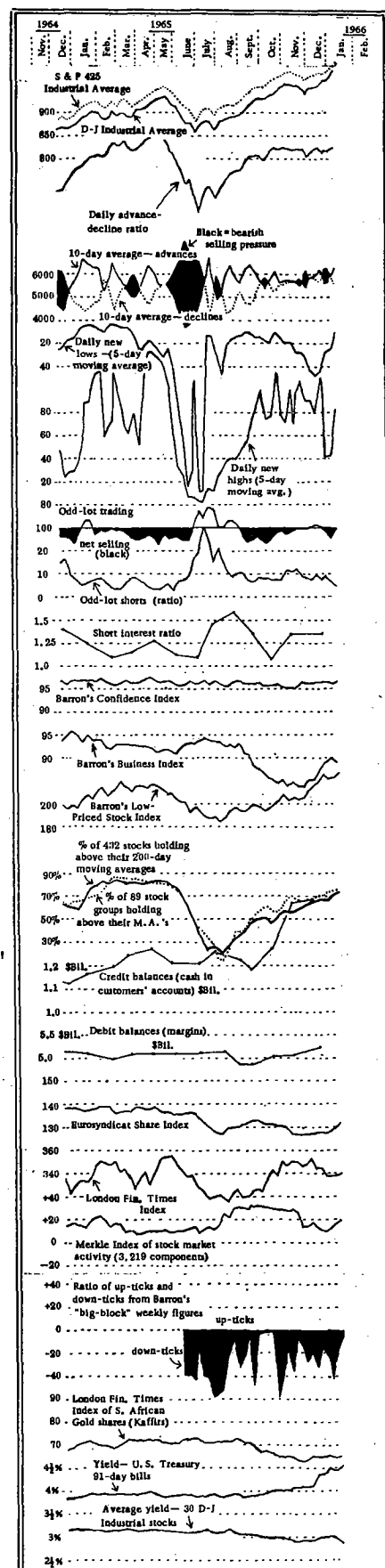
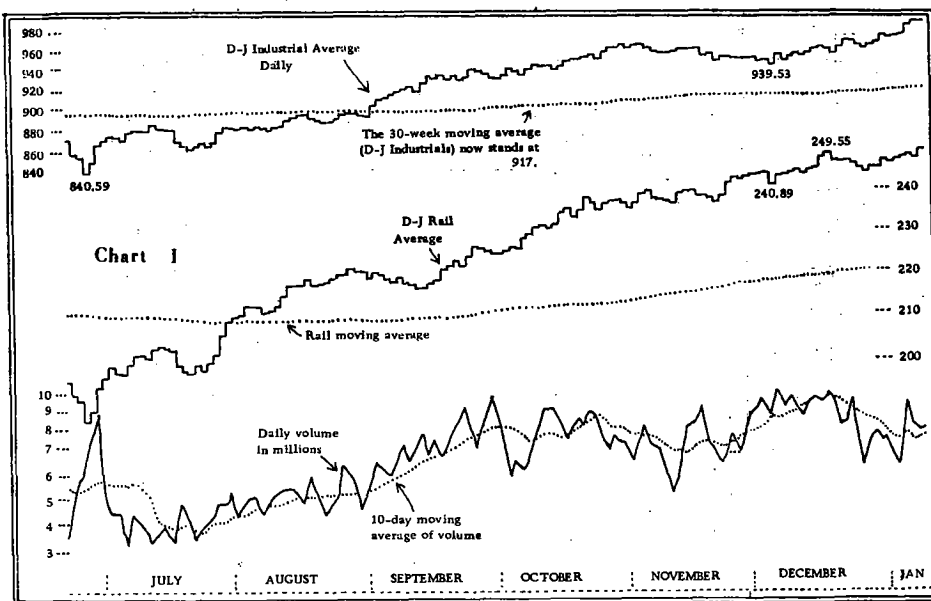
January 11, 1966

Letter 311

THE MARKET: According to Dow Theory a primary bull market will continue in force until the Averages have discounted the best that can be seen ahead. But how do we know when that fateful time has arrived? There is no way of knowing with absolute certainty, but the following are characteristics which are usually associated with major tops: the market becomes "frothy," rumors are rampant, average yields on stocks are low, soothsayers are placing the next potential trouble "a year or two away," the public is heavily committed, Wall Street captures the newspaper headlines and "Standing Room Only" signs adorn the boardrooms. In a more scientific vein, market technicians may note that odd-lotters are buying heavily and odd-lot volume may rise to 9 or 10% of total N.Y.S.E. volume. The short interest may have been declining for a few months, and the short interest ratio may be under 1. Other hints of an impending top may be provided by the Averages themselves. The two indicators may diverge for a few weeks or longer, accompanied by high volume. Or there may be an important non-confirmation or a series of non-confirmations.

But in the end the thing that every investor and analyst is attempting to discern is whether the Averages have discounted optimum business and market conditions. For at some theoretical level, the two indicators will have reached the point where they will have discounted the best of the bull market, and from that point on the Averages will be reflecting deteriorating conditions ahead. The period following the final peak in the Averages is, by definition, the beginning of a bear market.

Unfortunately, tops are usually very difficult to identify at the time of formation; they are always seen with crystal clarity in retrospect. What are some of the factors which are keeping market optimists optimistic at this time? Foremost is the huge 11.8 million share short interest, highest in Exchange history. Tops normally arrive when there are nothing but bulls in the pasture. The great short interest suggests that the bulls have a large army of opposition. Then too, the odd-lot public has never engaged in a buying spree on the whole rise since the June, 1962 lows. It would be normal for the public to do a good deal more buying than selling for at least a few months before the top. In other words, "technical market studies" merely attempt to place the psychological condition of the market on some sort of a scientific basis. The "seat of the pants" observer can insist that there is a great deal of froth and over-optimism in this market. The technician can say, "Oh yeah, then why are there 11.8 million shorts on Wall Street?"



Page 2 And the investor can argue that there aren't any attractive values in this market. To which the technician replies that values are only relative but meanwhile stocks go up and they go down.

What are some of the adverse factors which could effect the market in the year ahead. As I see it, two mighty "external" problems will hang over Wall Street like a sword of Damocles in 1966. The first is the money problem (interest rates) about which I have written a great deal recently. The second is Vietnam and the probability of expanding trouble in Asia.

Here is the big picture as I see it developing in Vietnam. General opinion has it that China wants or is willing to engage in war with the U. S. while Russia is conceded to be in favor of world peace. I do not agree with this thesis. As I see it, China is very much afraid of war with the U.S. (see Sundry Comments), and the fact is that China has backed away from real confrontation with the U.S. whenever that possibility has arisen. On the other hand, I believe that Russia would like to keep the war expanding in the hopes that the U.S. will ultimately turn her nuclear capabilities against China (note the reports of new giant Russian-made mortars in the hands of the Vietcong). If Russia can bring this off, she will have rid herself of the Chinese nuclear and population explosion threat, and she will have emerged as the second or greatest power on earth. Sensing this danger, my feeling is that the current pause in U.S. bombing is really a U.S. invitation to North Vietnam to de-escalate, to cut the war down to the size it was prior to McNamara's escalations. Thus I believe that the U.S. does not really believe the current "jet negotiations" will end the war, but the U.S. is inviting a general contraction in the size of the war.

THE DISCOUNT RATE: With the advent of the December, 1965, rise in the bank rediscount rate to $4\frac{1}{2}\%$, attention has been drawn to a number of studies which attempt to relate the rediscount rate to the action of the stock market. Two of the most important of these studies are the Weisenberger & Co. study by Mr. Edson Gould and the Hamilton Bolton study.

According to the Weisenberger "three step and stumble rule," any time there are three successive rises in any of the three rates set by the monetary authorities, the investor should beware, for the market is apt shortly to run into serious trouble. The three rates are (1) margin requirements for stocks, (2) the amount of reserves the member banks carry with the Fed, (3) the rate at which member banks rediscount paper at the Federal Reserve Bank.

Weisenberger cites the seven instances when his three step and stumble rule became operative. The dates for the first six signals were July, 1928; May, 1937; August, 1948; September, 1955; January, 1956; March, 1959. The data on these first six cases is interesting. The time lag from the July, 1928 Weisenberger signal to the final (September) 1929 high on the Dow was 14 months; during this time the Dow rose 86%. But the average time lag on the other five instances (from the time of the Weisenberger signal to the final peak on the Dow) was four months. The average price increase in the Dow during the other five instances was 10%. It is important to note that the latest or seventh Weisenberger signal was given in December, 1965, when the rediscount rate was raised to $4\frac{1}{2}\%$. The period ahead will prove or disprove the worth of the Weisenberger system.

Personally, I am more impressed by the Bolton study of rediscount rates. Bolton notes that "a rise of 50% from any low became a criterion, in and of itself, of entrance into a danger area, so far as stock prices are concerned." Bolton defines a "low" as the lowest rates which existed after a discount rate decline or series of declines. But because from 1946 to 1954 there was no discount rate decline, Bolton further states that a low can be any rate which after an advance held in effect for 18 months or longer (thus making it a sort of "floor").

Bolton notes that since 1919 there have been eight instances of rise of 50% or more from a rediscount rate base. The first seven of these plus-50%-levels were reached in January, 1920; August, 1929; October, 1931; April, 1946; August, 1948; September, 1955; May, 1959. The 1931 instance is not applicable because it occurred within a period in which a major bear market was in progress. A tabulation of the other six cases in which the discount rate was raised 50% shows that the years 1919 and 1948 produced time lags of two months in the signal; in other words, the bank rate was raised to 50% above the base two months after the Dow had already topped out. The other four 50% signals provided lead times of from one to seven months; in other words the Dow topped out one to seven months after the bank rate had been raised 50% above the base. The average of the two "lag signals" and four "lead signals" comes to a bit over a one month lead.

To bring the study up to date, the rediscount rate rise to $4\frac{1}{2}\%$ in December, 1965, constituted the eighth of Bolton's danger signals. If "average action" based on the tabulations above is to occur again, we would expect the peak on the Dow to occur sometime around late January or early February.

So much for some of the bullish technical and bearish fundamental considerations. What are the Averages saying? The last Letter stated: "For the near term, suffice it to say that all trends are bullish. A reconfirmation of the bull trend will occur if both Averages better their December highs of 969.26 and 249.55." Industrials bettered their December high during the opening sessions of 1966, and the new Industrial high was immediately followed by a dramatic spurt on the news of a "compromise" but inflationary rise in structural steel prices. On Monday (January 10) the Rail Average confirmed by closing above its December 17 peak of 249.55. The market has thereby stamped an "all clear" signal on the near-term to intermediate trend.

In the last Letter attention was directed to the lagging advance-decline ratio, but on January 5 this important indicator confirmed Industrials by pushing to an 8-month high. The disparity between the Dow and the Standard & Poor 500 Composite Index is still notable (the 500 is lagging as explained in Letter 310), and it remains to be seen whether this disparity is hinting of trouble in the period ahead. All in all, I accept the emergence of the two Averages into all-time high territory as a constructive development for the market over the foreseeable future.

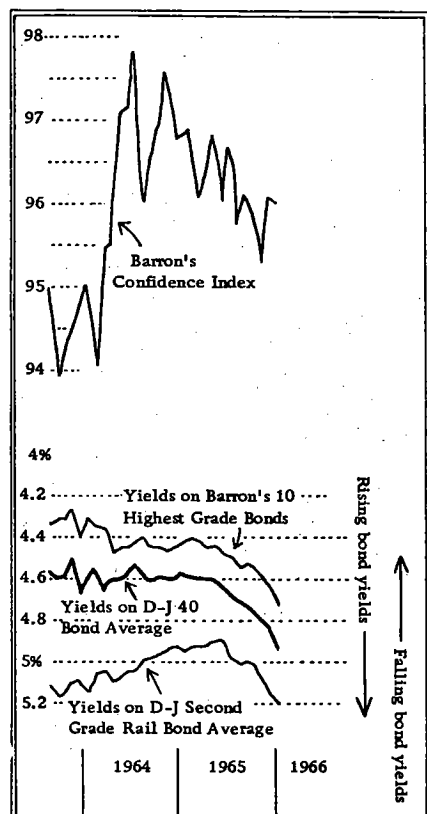
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The Composite Chart (Page 1) points up the fact that the Dow has put itself ahead of both the S & P Industrial Average and the advance-decline ratio (the latter is at a recovery high but still well below its May, 1965 high). The lagging breadth is also confirmed by the fact that the 5-day average of new highs has receded to 85. This suggests a rather mixed market, considering that the Dow is currently at an all-time high. As far as odd-lots are concerned the seasonal selling trend of late-December has now reversed to a seasonal buying trend (this is the normal January reinvestment period). Barron's Low-Priced Stock Index, now at 228, is near its high for the year. This index usually tops out well ahead of the Dow. The Eurosyndicat Index, reflecting some improvement in the European markets (particularly the Italian market), has risen to 132. At the bottom of the chart we note that yields on the 91-day Treasury bills (now at a high of 4.54%) and the yield on the Dow (2.87%) have produced an adverse yield spread of 1.67%, greatest in history. Conclusion: The technical underpinnings of the market continue bullish. Perhaps the item of greatest interest will be the announcement of the mid-January short position on the N.Y.S.E. The inflation thesis is now appearing almost

daily in newspapers across the nation, and this is helping to "justify" the purchase or retention of almost any stock at any price. Adding flames to the fire is the announcement by Democratic leaders in Congress that the Vietnam war is not sufficient reason to forestall new Great Society spending programs.

BEHIND THE CONFIDENCE INDEX: Many subscribers have expressed amazement because Barron's famous confidence index (C.I.) has held up relatively well in the face of a general decline in all bond markets. They forget that the C.I. is the ratio of the yield on Barron's 10 Highest Grade Bonds and the yield on the broad D-J 40 Bond Average. Theoretically, when bond investors sense economic trouble ahead they will move to up-grade the quality of their bond portfolio. This is reflected by rising high grade bond prices and declining high grade bond yields (all in relation to lower grade bond yields). Under these conditions, the C.I. will fall. Conversely, when bond buyers are confident, they will forsake safety in favor of income. Under these conditions the yields on high grade bonds and average grade bonds will converge and the C.I. will reflect this by advancing.

The D-J 40 Bond Average is composed of four categories of bonds, and this is what makes it a broad indicator of general bond prices. The four components of the 40 Bond Average are (1) High Grade Rail Bonds, (2) Second Grade Rail



SUNDRY COMMENTS: In the face of price rises in selected steels by U. S. companies, the following makes interesting reading and explains to some extent the Administration's fears regarding the U. S. pricing itself out of world markets. (From the Dec. 2 London Economist): "An approaching world steel recession is already squeezing Japan's producers. . . . The 'Big Six' Japanese steel makers, at last facing up to the consequences of a slackening economy combined with a tighter world market, led the industry in meeting the situation by voluntarily slashing production up to 10%. . . . Japanese steel producers, now the largest exporters in the world, are concerned that there is some sort of threat building up." (From the Wall Street Journal, Jan. 3): "In 1965 (U.S. steel imports) soared to an estimated 10 million tons, with the foreign mills supplying roughly one of every nine tons of steel used in this country."

Some of the "fruits" of past and current spending sprees are now coming out in the open. Led by the example of the U.S. Government, many states and cities are now producing almost unbelievable deficits. New York City, faced with a \$300 million deficit, is mulling over a 2% income tax on residents and non-residents alike. The state of California is also faced with a \$300 million deficit and is thinking about raising its already high state income tax. Other examples which are not atypical: the city of Rochester, N.Y. has run up its debt 50% in the last five years; Springfield, Mass. has boosted its debt 62% in six years. Cities now levying an income tax include Detroit, Columbus, Cincinnati, Dayton, Philadelphia, St. Louis, Louisville, Washington, D. C., and the trend suggests more to come.

The new national budget will be between \$110 and \$115 billions — probably nearer the latter. Of this amount approximately \$63 billions will be for defense and \$13 billions will be for interest on the national debt. This means that almost 70% of U.S. Government spending in 1966 will be earmarked for guns and interest, both of which are non-productive. Most of the interest will go towards paying debt accumulated during previous wars. Investors are taking all this spending to be inflationary. But I have been stressing the thesis that a war on top of our already mountainous national debt can run interest rates sky-high — and be deflationary.

The market for Government debt has been deflating at an accelerating rate for months. Of the 40 listed Government bonds, I now count 7 at yields of 4.9% or better. How long will it be before the market is confronted by another "magic five," a new Government issue bearing the magic interest rate of 5%? If the Government starts paying 5% (which I believe they will) and expenses continue to mount (note Johnson's request for an additional \$13 billion for Vietnam), we will see money siphoned out of every corner of the nation and into Uncle Sam's pockets.

With all the thousands of articles and statements now being issued on Vietnam, no one suggests that Vietnam could be part of Red China's plan for economic war against the U.S. But this writer believes that's just what the Vietnam war is. On a cold appraisal, this war is coming at a very unfortunate time for the U.S., furthermore it is costing the U.S. billions of dollars and it is costing China very little. Part of these newly created billions of U.S. dollars are accumulating in central banks throughout the world, and they represent a steadily mounting call on U.S. gold. My own opinion is that with the Vietnam situation going the way it is, and with budget deficits mounting, foreign central bankers are fast approaching the "panic stage." That stage is defined as the point at which foreign central bankers won't be polite about calling in gold for dollars. All this China knows.

(3) Industrial Bonds, (4) Utility Bonds. But the most speculative and most volatile components of the 40 Bond Average and the ones that effect this Average most in price are the 10 Second Grade Rails.

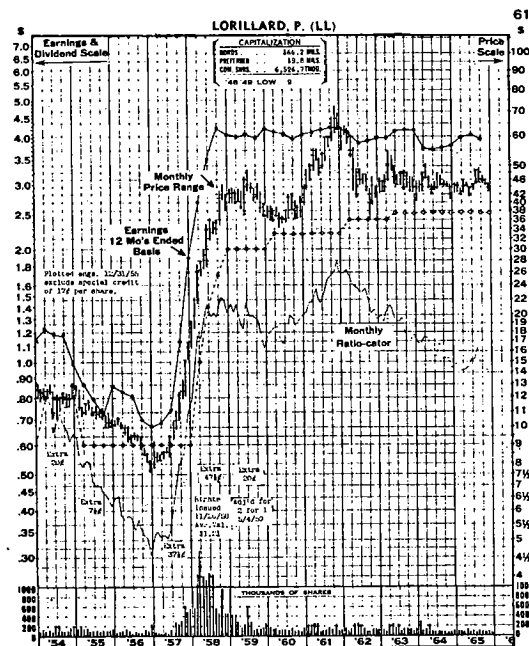
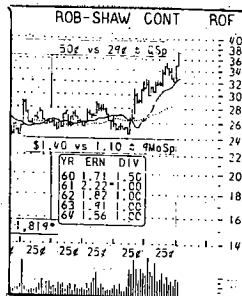
The bond and money markets are always of great importance, but in my opinion they may hold the key to the entire stock market and economic situation during 1966 (see Page 1, Letter 309). For this reason, I want subscribers to understand exactly what is occurring in the bond yield picture. Note on the accompanying chart that the peak in the C. I. corresponded to the point at which the yields on Barron's 10 Highest Grade bonds and the yields on the broad D-J 40 Bond Average were closest together. Theoretically, if these two yields touched, the C.I. would stand at 100.

All during 1964 and up to mid-1965 the speculative Second Grade Rail Bonds were advancing. This in itself suggested tremendous confidence among bond buyers. In fact, so sensitive is this Second Grade Rail Bond Average (it is, of course, keyed to confidence in rail equities) that some analysts believe the Second Grade Rail Bonds actually forecast (about six months in advance) the general direction of the stock market. The rising trend in Second Grade Rail Bonds was the primary influence in holding up the entire D-J 40 Bond Average during the first half of 1965.

In early 1965 most bond yields "flattened out," but it was not until mid-1965 that the yields on the Second Grade Rail Bond yields started up (as the Rail bonds themselves dropped). The leverage created by the rise in Second Grade Bond Yields served to send

Page 4 the entire 40 Bond Average yield up, and the C.I. declined mildly through the second half of 1965. But this is important — the rise in bond yields during most of late 1965 and to the present has been indiscriminate. All bonds have fallen in price during the past seven months. In other words, the rise in bond yields since mid-1965 has been roughly the same, regardless of the classification of bond. For this reason, there has been little change in the level of the C.I. We must remember that regardless of any rise in bond yields, the C.I. will only decline if the spread between high grade and average bond yields increases in favor of high grade bonds.

STOCKS: While the recommendation of stocks for speculative purchase requires more than average intestinal fortitude at this time, a few assorted comments will be ventured here. The Truck stocks in general are acting well, and a leading company in this group is Mack. The stock has been running back and forth in a giant "rectangle pattern" bordered by 53 on the upside and 28 on the downside for the past eight years (see large monthly chart). The trend of declining relative strength in Mack touched its low in 1965 and reversed to the upside in late 1965. Against 90¢ earnings per share in 1965, the 1965 Mack earnings will probably run about \$2.50 in 1965 with a potential \$5.00 per share in 1966. At any rate, if Mack breaks out of the massive rectangle as shown on the chart this stock could become an excellent speculative vehicle. Speculators might purchase Mack here with stop-loss placed at 44.

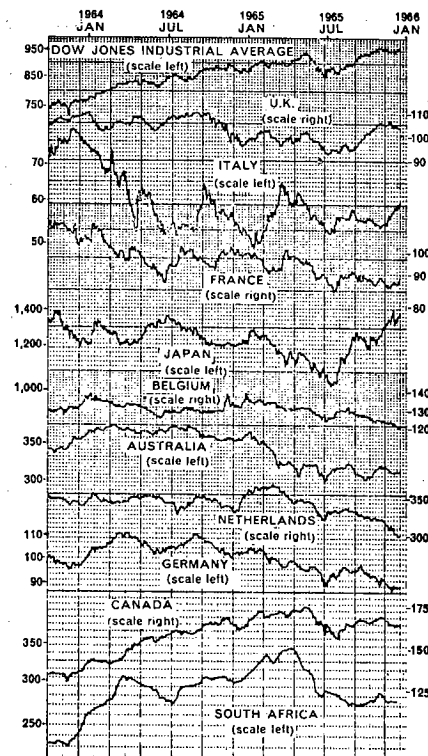


In Letter 304 I drew attention to six stocks which showed promise. These were Fansteel, Eversharp, General Time, Marquardt Corp., Robertshaw-Controls and Union Bag-Camp Paper. One of these, Robertshaw, is still attractive and is moving out of a base that extends back to 1962. Volume on the recent rise has been the highest for this stock in 10 years. Robertshaw could still have considerable distance to go (see chart).

BILLS AND BONDS: Yesterday's 91-day Treasury bill yields rose to 4.58%. This was above the bank rediscount rate and the highest bill yield in six years. Subscribers are asking what to do if the Government announces a new "Magic Five" (i.e., a note bearing 5% interest). My answer, I would not put more than 20 to 30% of my money in any fixed income Government security with a maturity of over a year. However, if another four or five year Treasury note bearing interest of 5% came along, I would be tempted to put about 20% of my assets into it. Why not more? Because I think the Government may well pay more before the next year is out, and I don't want to get "locked in" to the bond market (regardless of yield) with more than 20% of my assets.

The latest profile of leading foreign stock exchanges (courtesy of Security Analysts Ltd., 50 Denmark Hill, London, S.E. 5) shows the N.Y.S.E. as the sole market at all-time highs. Japan seems to have established an important reversal in its five-year bear market. Italy too has scored a definite upward zig-zag. On the other hand, established major bear trends continued in France, Belgium, Holland, and Germany. The international picture has seldom been so mixed, but ultimately we can expect all Free World markets to move together.

NOTICE: The response to Economic Trends (Letter 310) has been gratifying, and the first issue should be mailed a few days past the middle of the month. I want to apologize for two indicators which were not labeled, but in the next issue we will strive for perfection. New subscribers who have not seen an issue of this new service (which is mailed every two weeks and covers 90 important market and economic indicators and ratios) may write for a free copy.



Small weekly chart of Robertshaw courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Large monthly chart of Mack Truck courtesy of Securities Research Corp., 211 Congress St., Boston, Mass. 02110.